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Docket No. 01-0707
ICC Staff Exhibit 10.00

REBUTTAL TESTIMONY

of

Steven R. Knepler

Accounting Department

Financial Analysis Division

Illinois Commerce Commission

**Reconciliation of revenues collected under gas adjustment
charges with actual costs prudently incurred.**

The Peoples Gas Light and Coke Company

Docket No. 01-0707

February 18, 2005

OFFICIAL FILE
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Witness *Knepler*
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1 **WITNESS IDENTIFICATION**

2 Q. Please state your name and business address.

3 A. My name is Steven R. Knepler. My business address is 527 East Capitol
4 Avenue, Springfield, Illinois 62701.

5 Q. Have you previously filed testimony in this proceeding?

6 A. Yes. My Direct testimony was filed in August 2003 as ICC Staff Exhibit 1.00 and
7 my Additional Direct / Rebuttal Testimony was filed in January 2005 as ICC Staff
8 Exhibit 5.00.

9 Q. What is the purpose of your rebuttal testimony?

10 A. The purpose of my rebuttal testimony is to respond to comments made by
11 Company witness Zack regarding Staff's recommendations (1) for a
12 management audit of Peoples' gas purchasing practices, gas storage operations
13 and storage activities, (2) for internal audits of its gas purchasing practices, and
14 (3) to reopen the fiscal 2000 PGA reconciliation.

15 **AUDIT RECOMMENDATIONS**

16 Q. Peoples witness Zack states that "Imposing both an external audit requirement
17 and an ongoing internal audit requirement is unnecessarily burdensome"

18 (Respondent Ex. K, p. 14, lines 290-291). Do you care to comment on Mr.
19 Zack's statements?

20 A. Yes. I continue to believe that both the (external) management audit¹ of Peoples'
21 gas purchasing practices, gas storage operations and storage activities and
22 annual internal audits² of its gas purchasing practices are warranted. The
23 external management audit is intended to be a forward looking evaluation of the
24 internal control requirements that need to be implemented to ensure that
25 ratepayers are protected when purchasing and storage decisions are made. The
26 purchasing and storage decisions evaluated during the management audit
27 include, but are not limited to, the awarding of gas supply contracts, the
28 allocation of company owned storage, the decision to lease storage capacity, and
29 storage injection and withdrawal activities. The annual internal audit is a
30 historical evaluation of transactions and their compliance with the internal
31 controls established by the management audit. With respect to Staff
32 recommendations, the annual internal audits are a necessary follow-up to the
33 management audit. These audits are needed given the improper accounting
34 Peoples has done with respect to maintenance gas³, supporting documentation
35 detailing the reasons for entering into certain gas transactions⁴, and the
36 breakdown in internal controls related to Transactions 16 and 22⁵. The
37 combination of a management audit and internal audits would aid in the

¹ Recommendation at ICC Staff Exhibit 5.00, p. 22, lines 505-520.

² Recommendation at ICC Staff Exhibit 5.00, p. 22, lines 493-498.

³ See ICC Staff Exhibit 1.00, pp. 14-22 (Maintenance Gas: Improper Accounting).

⁴ See ICC Staff Exhibit 1.00, p. 28 (Records and Procedures).

⁵ See ICC Staff Exhibit 1.00, p. 28 (Transactions 16 and 22).

38 correction of the aforementioned improper accounting procedures, as well as
39 provide information about Peoples transactions and practices, that would be
40 useful in future PGA reconciliation cases.

41 In addition to the aforementioned problems with internal controls, Staff has
42 discovered what it believes are serious breakdowns in internal control regarding
43 undocumented transactions, oral agreements, and revenue sharing.⁶ These
44 internal control breakdowns which are supported, in part, by the findings of the
45 internal audit of enovate's operations.⁷ Therefore, it is a logical, two-step
46 approach to first establish a series of internal control procedures (management
47 audit) and second, to evaluate on an annual basis the Company's decisions and
48 transactions on how well it complied with the guidelines establish by the
49 management audit.

50 Q. Mr. Zack further states that "...it is important to remember that the events that are
51 subject of Staff's testimony occurred in almost three and one-half years ago"
52 (Respondent Ex. K, p. 14, lines 292-294). Is it appropriate to dismiss Peoples
53 actions just because they occurred nearly three and one-half years ago?

54 A. No. Although these events may have occurred nearly three and one-half years
55 ago, the Respondent is still responsible for its actions. These proceedings, along
56 with the 2002, 2003, and 2004 PGA reconciliations, are open dockets. Each
57 docket requires the review of the Respondent's accounting records to determine

⁶ See ICC Staff Exhibit 5.00, pp. 13-17 (Management Audit / Internal Audit).

⁷ Docket No. 01-0707: ICC Staff Exhibit 9.00 (Hathhorn Additional Direct / Rebuttal Testimony), Attachment E.

58 the prudence of its purchases. The PGA reconciliations by their nature are
59 backward-looking in order to analyze the actual cost and revenues incurred by
60 the utility in the reconciliation period. Since the PGA reconciliations provide
61 dollar for dollar recovery, it is appropriate for the Company to undergo more
62 extensive analysis when the conditions are warranted.

63 As noted by the Commission's Order Commencing PGA Reconciliation
64 Proceedings,

65 **"Section 9-220 requires the Commission to initiate annual public**
66 **hearings to determine whether the clauses reflect actual cost**
67 **of...gas...purchased to determine whether such purchases were**
68 **prudent, and to reconcile any amounts collected with actual costs**
69 **of...gas...prudently purchased. In each proceeding, the burden of**
70 **proof shall be upon the utility to establish the prudence of its cost**
71 **of...gas...purchases and cost."**⁸

72 Thus, Section 9-220 requires Staff to review the Company's filing. A
73 management audit would provide a critical, independent review of issues
74 discovered in this proceeding that carry over to the FY 2002-2004 reconciliations.
75 The additional audits shift the cost burden for investigating the issues to the
76 Company (instead of the Commission, CUB and the City).

⁸ Illinois Commerce Commission, On Its Own Motion, Order Commencing PGA Reconciliation Proceedings, Docket No. 01-0707, Order Date November 7, 2001.

77 Q. Company witness Zack states, on page 3 of his additional rebuttal testimony, that
78 the Company proposes that it provide Staff information about its current gas
79 supply and capacity procurement process, and, if Staff wishes to initiate a
80 proceeding at that point, it can make the appropriate recommendations to the
81 Commission. Please comment.

82 A. The purpose of this proceeding is to reconcile prudent costs and revenues for a
83 past historical period. It is not appropriate for the Commission to evaluate the
84 Company's current internal controls within this reconciliation. It is appropriate for
85 this Commission to recommend to the Company to take action to evaluate
86 current practices in light of the findings regarding the Company policies in 2000-
87 2001 to safeguard ratepayer interest.

88 Q. Peoples Gas witness Zack states that Staff's internal audit proposal is not
89 unreasonable, but the Company is opposed to the recommendation absent a
90 deadline provision. Please comment.

91 A. Staff's management audit and internal audits proposals are to be considered in
92 tandem. The management audit establishes internal control procedures (i.e.,
93 "what actions the Company should implement to correct the identified problem")
94 and the internal audits determine how effective the Company was in
95 implementing the internal controls (i.e., "whether the actions it has implemented
96 has corrected the problems identified in the management audit"). Peoples Gas
97 must demonstrate, over a period of time, to the Commission, its board of

98 directors and stockholders that the internal audits are unnecessary. Peoples'
99 future performance will determine the time-period of the internal audit
100 requirement. Again, Staff continues to support its recommendations for a
101 management audit and an internal audit.

102 **REOPENING OF 2000 PGA RECONCILIATION**

103 Q. Beginning on page 15 of his additional rebuttal testimony, Peoples witness Zack
104 discusses the Company's opposition to reopening Docket No. 00-0720, the 2000
105 PGA reconciliation. Mr. Zack believes that the reason for reopening the 2000
106 reconciliation is because "Staff has concluded that the GPAA was imprudent."
107 Besides the imprudence of the GPAA, are there other issues for the Commission
108 to consider when deciding whether to reopen the 2000 reconciliation?

109 A. Yes. Although Staff believes the Company has failed to show that the GPAA is
110 prudent, Staff further believes the Commission should consider the entire record
111 in this proceeding that includes:

- 112 • The imprudence of the GPAA;
- 113 • The inter-relationship among Enron and its affiliates and PEC and its
114 affiliates;
- 115 • The apparent internal control weakness as identified in the internal audit;
116 and
- 117 • The imprudent use of storage gas and storage facilities (i.e., negative
118 bank of 3rd party gas).

119 **SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS**

120 Q. Although Staff is proposing an adjustment to reduce gas costs for non-tariff
121 revenues (in accordance with the requirement of Part 525.40(d)), you did not
122 include a specific recommendation in your previously filed testimony regarding
123 the accounting treatment of these transactions in the future PGA reconciliation.
124 Should Staff's recommendations include a specific recommendation regarding
125 the treatment of non-tariff revenues in future reconciliations?

126 A. Yes. Staff believes that its treatment on non-tariff revenues is inherent in its
127 testimony, but now has included the preferred treatment for future reconciliations
128 as Recommendation 11.

129 Q. In your previously filed testimony you made several recommendations. Please
130 summarize the current status of each recommendation.

131 A. The Company has agreed to account for maintenance gas as recommended by
132 Staff. Thus, Recommendations 3, 4, 5, 6, and 8 are agreed to by the Company.
133 Additionally, the Company has agreed to revise its intercompany service
134 agreement⁹, thus, Recommendation 2 is in agreement. As noted in my additional
135 direct/rebuttal testimony, the reporting period for Recommendation 8 has been
136 revised from the quarter ending September 30, 2004 to the quarter ending
137 September 30, 2007. Recommendations 1, 7, 9 and 11 are disputed and await a
138 Commission ruling. None of the dollar amounts I set forth in my additional

⁹ Respondent's Ex. K, pp. 13-14, lines 276-284.

direct/rebuttal testimony changed in this round of testimony, therefore, I have no
schedules. My conclusions and recommendations are the following:

• Recommendation 1: [Contested]

I recommend that the Commission adopt Staff's proposed PGA reconciliation as reflected on ICC Staff Exhibit 5.00, Schedule 5.01. Staff's reconciliation shows that \$91,987,033 is to be refunded to Peoples' PGA customers via the Commodity Gas Charge (CGC) through an Ordered Reconciliation Factor (Factor O) to be reflected in the Company's first monthly PGA filing submitted after the date a final order is entered in this proceeding;

• Recommendation 2: [Agreed]

I share Staff witness Hathhorn's recommendation that the Company immediately update its operating agreement approved by the Commission in Docket No. 55071;

• Recommendation 3: [Agreed]

I recommend that the Commission direct Peoples to account for all gas physically injected into the Manlove Storage Field by including the cost associated with maintenance gas in the amount transferred from purchased gas expense to the gas stored underground account (Account 164.1);

• Recommendation 4: [Agreed]

I recommend that the Commission direct Peoples to account for the portion of gas injected into the Manlove Storage Field in order to maintain pressure (i.e., maintenance gas) as credits from Account 164.1, Gas Stored Underground and as charges to Account 117, Gas Stored Underground (for the recoverable portion of cushion gas) or to Account 101, Gas Plant (for the nonrecoverable portion of cushion gas);

• Recommendation 5: [Agreed]

I recommend that Peoples be ordered to revise its maintenance gas accounting procedures related to gas injected for the benefit of the North Shore Gas Company and third parties to require those entities to bear the cost of maintenance gas;

• Recommendation 6: [Agreed]

I recommend that Peoples Gas be ordered to submit its revised maintenance gas accounting procedures to the Commission's Chief Clerk with a copy to the Manager of the Accounting Department within 30 days after the date a final order is entered in this proceeding;

• Recommendation 7: [Contested]

I recommend that Peoples perform an annual internal audit of gas purchasing and submit a copy of the audit report to the Manager of the Commission's

177 Accounting Department by May 1 of the year following the audit until the
178 Commission finds that an internal audit is no longer necessary upon a formal
179 request by the Company;

180 • Recommendation 8: [Agreed]
181 I recommend that Peoples submit quarterly reports reflecting its use of journal
182 entries regarding maintenance gas to the Manager of the Commission's
183 Accounting Department within 45 days of the end of each quarter after the
184 date a final order is entered in this proceeding through the quarter ending
185 September 30, 2007;

186 • Recommendation 9: [Contested]
187 I share Staff witnesses Anderson's, and Rearden's recommendation that
188 Peoples Gas should engage outside consultants to perform a management
189 audit of its gas purchasing practices, gas storage operations and storage
190 activities. The firm selected to perform the management audit is to be
191 independent of the Company, Staff and Interveners to Docket Nos. 01-0706
192 and 01-0707, and approved by the Commission. The management audit
193 should be managed by the independent directors of Peoples Energy
194 Corporation's audit committee. Monthly reporting of the progress of the
195 conduct of the management audit should be submitted to the Bureau Chief of
196 the Commission's Public Utilities Bureau, with a copy to the Manager of the
197 Commission's Accounting Department, until the management audit report has
198 been submitted. Upon completion, which shall occur no later than 12 months
199 after the date a final order is entered in this proceeding, copies of the
200 management audit report are to be submitted to the Public Utilities Bureau
201 Chief and the Manager of the Accounting Department.

202 • Recommendation 10: [Contested]
203 I recommend that the Commission reopen Docket No. 00-0720, Peoples Gas'
204 2000 PGA reconciliation.

205 • Recommendation 11: [Contested]
206 I recommend that Peoples Gas account for non-tariff revenue in accordance
207 with Section 525.40(d) of the PGA rule.

208 **CONCLUSION**

209 Q. Does this question end your prepared rebuttal testimony?

210 A. Yes, it does.